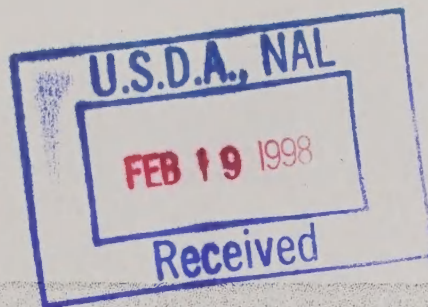


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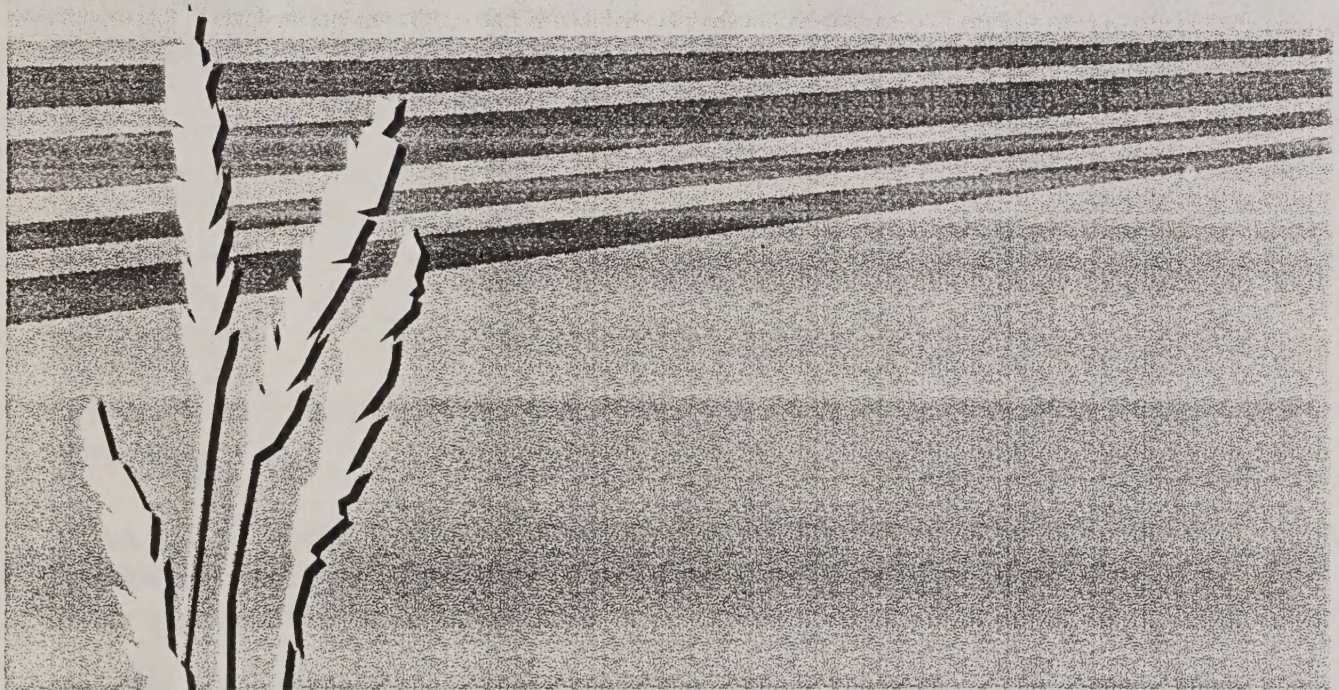
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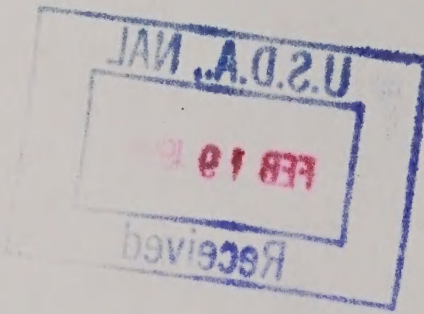
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U.S. FARM POLICIES:

IMPLICATIONS FOR THE FUTURE



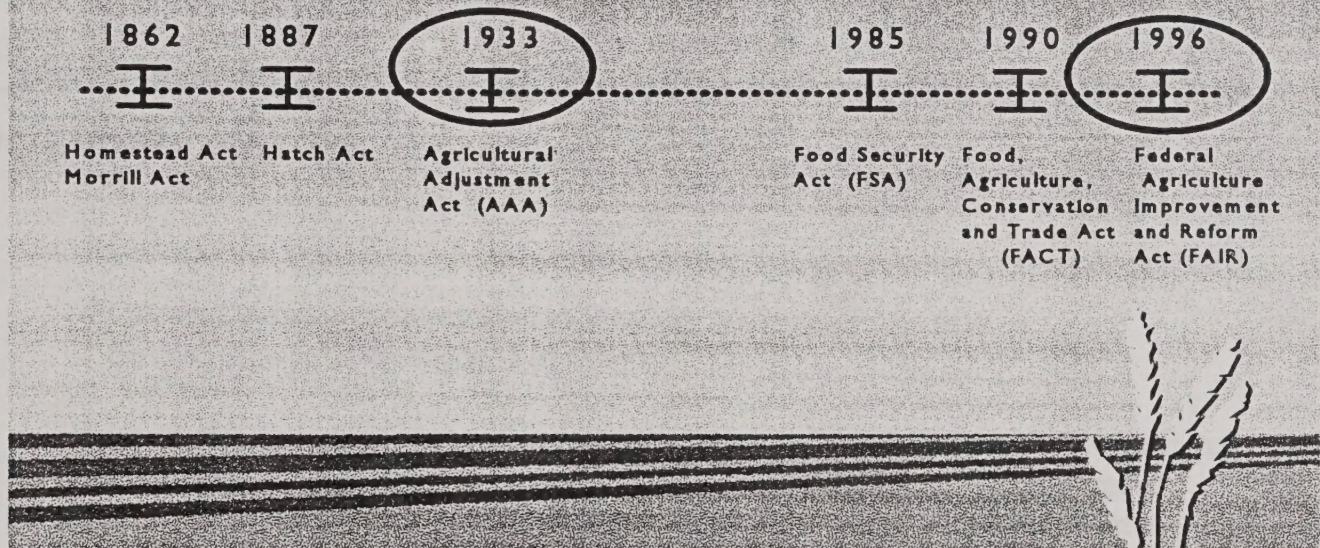


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U.S. FARM POLICY



- 1933 Agricultural Adjustment Act (AAA) was a landmark piece of legislation in the history of American farm policy--a major break from previous legislation. Prior to 1933, "farm" legislation had the intent to provide greater opportunities in the agriculture sector.
- 1933 AAA was designed to address the "farm problem"--low prices (supply surpluses); instability and uncertainty in farm prices and incomes; and low incomes in farm and rural communities. The 1933 AAA gave the Government a new role in the "management" of the farm sector.
- AAA and subsequent legislation introduced commodity programs which included production and marketing controls and price and income support programs for many of the most important farm commodities.
- Conditions in U.S. agriculture and the broader economic and policy environment have changed dramatically since the 1930's, but until the 1996 Federal Agriculture Improvement and Reform (FAIR) Act, U.S. farm policy revolved around mechanisms that tied price and income supports to production controls.

Conditions have changed since the support programs were originally started.

- 40 percent of population engaged in farming, while today less than 2 percent of population engaged in farming.
- Farms were diversified, but today they are more specialized. The proportion of farms producing program commodities has declined over time as a result of increased specialization of production. For example, in 1949, 1 in 5 farms produced cotton, compared to 2 percent in 1992. In 1949, 59 percent of all farms produced corn for grain compared to 26 percent in 1992. In 1949, 55 percent of all farms produced dairy products compared to 7 percent in 1992.
- Farm commodity programs were developed when the average income of farm households was about one-half that of all U.S. households. With the possible exception of the World War II period, this low relative income status persisted well into the 1960's. Farm households generally achieved income parity with all U.S. households during the 1970's. The situation has remained that way, except for the early 1980's.
- Improved access to rural non-farm jobs and off-farm income has played an important role in farm households achieving income parity. Farm households, on average, depend more on income from off-farm sources for family living than on income from farming.

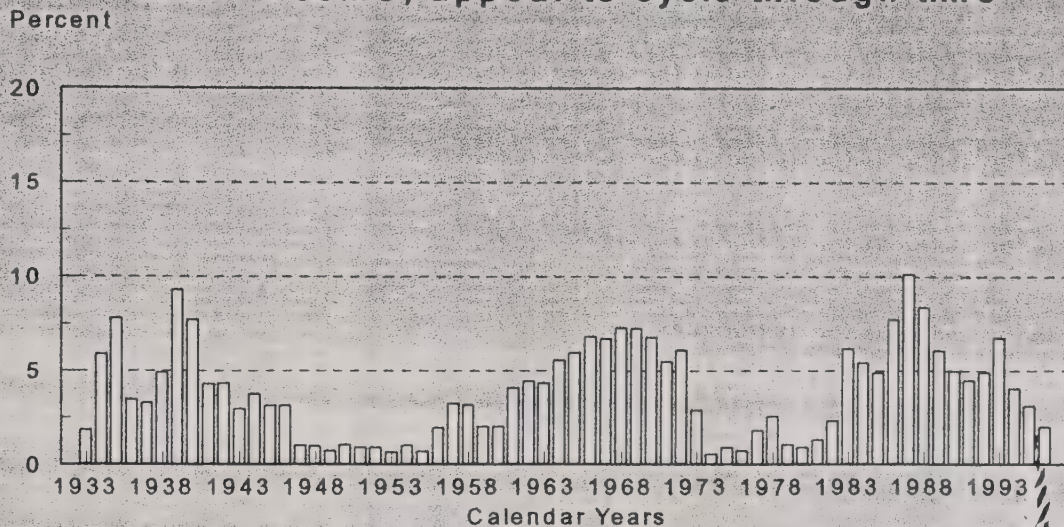
PRESSURE FOR REFORM

- Programs originated in the 1930's
- Designed to stabilize and boost farm income
- Program rules were restrictive
- Acreage Reduction Programs allowed competitors to expand
- Federal budget deficit: Costs were high and variable



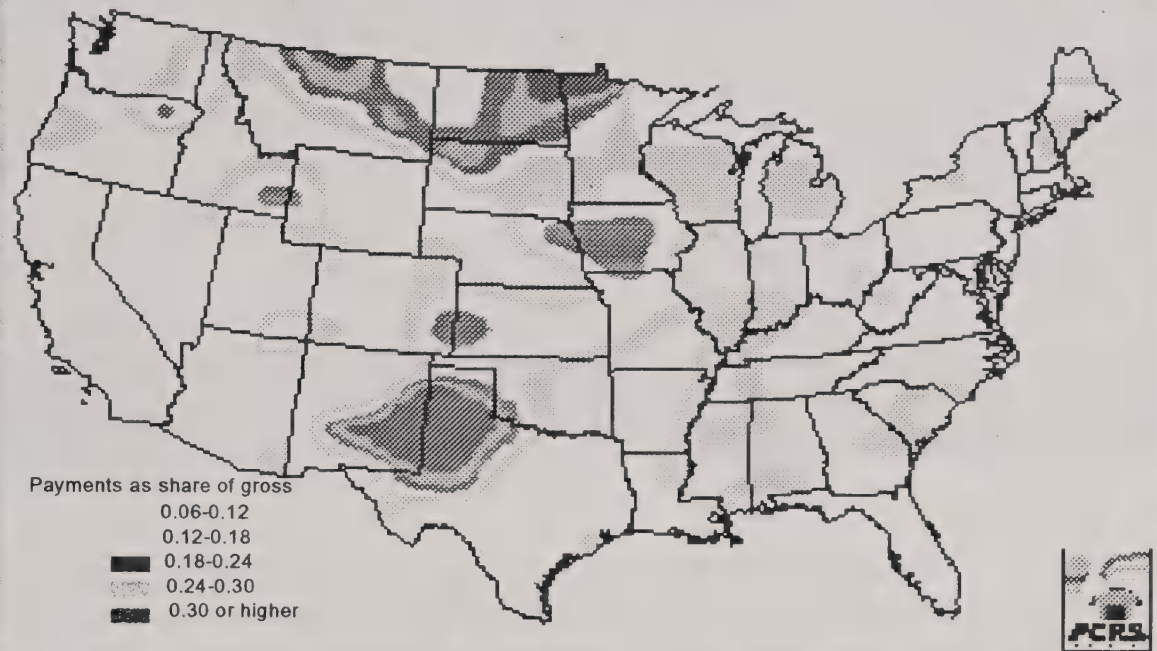
- Changing structure of the U.S. agriculture sector and increasing dependence on world markets built pressure for reform in U.S. farm policy.
- Program rules constrained most efficient producers. Production decisions tied to program parameters not to market prices.
- Program rules at times restricted the sector's ability to fully compete in the global market place. Acreage controls for some crops allowed competitors to expand.
- Government expenditures for agriculture rose to peak levels in the late 1980's adding to the Federal budget deficit.

Government Payments, as a Proportion of Gross Cash Income, appear to cycle through time



- The farm sector's dependence on Government programs and payments has varied over time. One measure of the ebb and flow of the sector's dependence on Government programs is the level of direct government payments to producers as a percent of gross cash income.
- Direct Government payments is not the only measure of Government support for the farm sector. Incomes were also protected by a system of price supports that kept prices at or above a set floor price--the Government acting as a residual market adjustor and accumulating stocks under weak market conditions. Also, annual supply management programs required the idling of land--more land being idled under weak market conditions.
- Government payments over the 1933 to 1995 period ranged from 1 to 10 percent of gross cash income. The level, however, is not as important as the cyclical nature of the farm sector's dependence on government programs.
- Government payments are linked countercyclically to market conditions. Under weak market conditions (low prices), government payments increase. Government payments tend to fall when market demand is strong and prices high.
- Important to keep this countercyclical nature of government programs in mind--it becomes important later in understanding the implications of the FAIR Act.

Government Payments: Share of Gross Cash Income



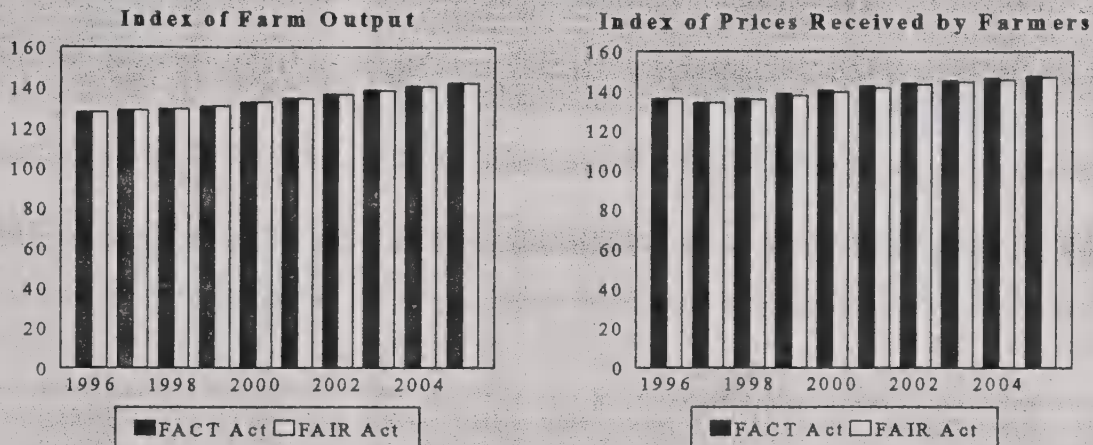
- While direct government payments are relatively low (1 to 10 percent) for the sector as a whole, direct government payments are more important in some regions than in others.
- In parts of the Southern Plains, the Western Corn Belt, and the Northern Plains, producers depend on government payments for 30 percent or more of their gross cash income. While many factors influence the dependence on government payments, the crop mix and the specialized nature of production, the size of the operation, and the degree of natural advantages (climate and soil productivity) are important determinants of dependency in these regions.
- The regional pattern of dependency on government payments, like the countercyclical pattern, is an important factor in understanding those areas likely to experience the greatest adjustment burden/ pressure from the 1996 FAIR act.

1996 FEDERAL AGRICULTURE IMPROVEMENT AND REFORM ACT (FAIR)

- Less Government Intervention
 - Major step toward phasing out commodity programs
- FAIR Nearly Completes Market Orientation
 - Decouples planting decisions
 - Eliminates annual supply control programs
 - Government payments no longer related to market price
- General Impacts
 - Production effects strongly tied to market forces and CRP
 - U.S. more competitive
 - Income variability increases
 - Producers must take more responsibility for managing price risk

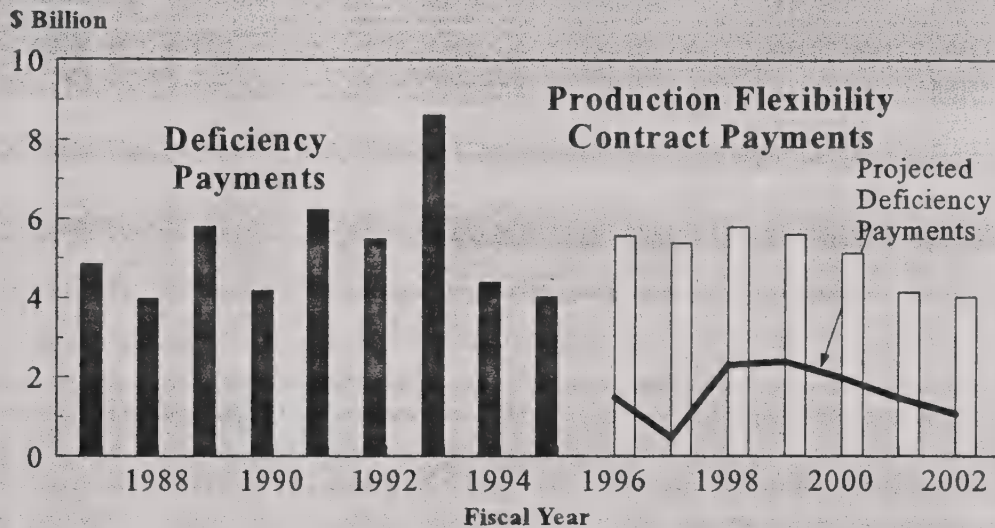
- The FAIR Act will likely become another landmark in U.S. farm policy. First, it takes a major step toward phasing out commodity programs that have been in existence, in some form, since the 1930's. Secondly, it takes the United States to an almost fully market oriented farm policy.
- In the market orientation sense, the FAIR Act is more evolutionary than revolutionary. FAIR completes the process that began with the two previous farm bills (1985 and 1990) of cutting the link between farm production decisions and government policy signals sent through traditional commodity programs. FAIR completes the move to market orientation by: decoupling planting decisions from program parameters; eliminating annual supply control programs; and **most importantly** no longer ties government payments to market conditions.
- Dependence on market forces will generate economic efficiency gains and make the sector more competitive in the global marketplace. It could potentially add to income variability and, therefore, a need for producers to take more responsibility for managing market/price risk--a responsibility the government gives up under FAIR.

Impact of Legislation on Output and Prices Is Minor



- Projections from USDA and the Congressional Budget Office (CBO) suggest that levels of supply, demand, and prices for most commodities under FAIR would differ little from the levels projected under a continuation of the old (1990 FACT Act).
- Two major reasons: First, operator decisions, at least at the margin, were already being driven by market forces, more so than program parameters, following the 1990 farm legislation.
- Secondly, the next ten years point to bullish commodity markets based on expected strong export demands that offset further government withdrawal of price and income support mechanisms.
- Farm income under FAIR will likely be greater during the transition to 2002 than under continuation of the 1990 FACT provisions, largely due to the contract payments under FAIR.

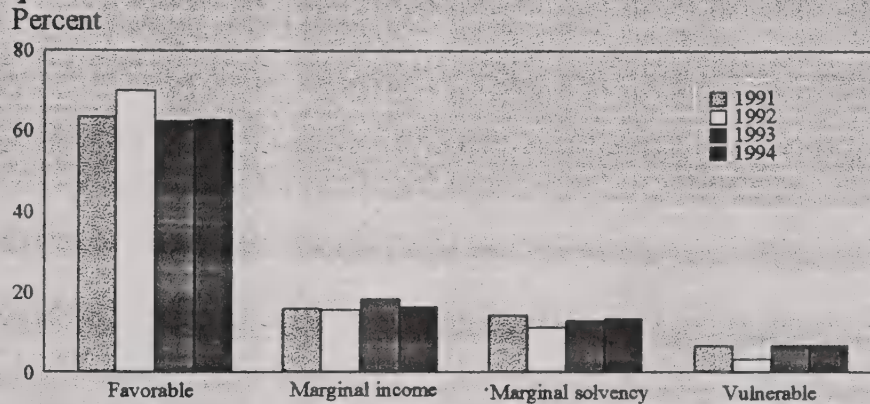
Farm Income Higher as FAIR Act Contract Payments Exceed Projected FACT Act Deficiency Payments



- Under a continuation of the 1990 FACT provisions, projected government payments (called deficiency payments) would have been substantially lower than the contract payments called for under the 1996 FAIR Act. So farm incomes (cash income from the market plus government payments) would be greater.
- Phasing out of commodity programs is not likely to lead to any large-scale displacement of farm operators on a sector-wide basis. First, transition payments will add to farm income and can be used by producers to facilitate whatever financial restructuring/rationalization that needs to take place.
- Secondly, the farm sector, in the aggregate, goes into FAIR in sound financial position.

Commercial Farm Financial Position

Most commercial farms that participate in government programs are not dependent on government payments (5 percent or less of gross farm income) and are in a strong financial position.



Even though payments do not represent a significant source of income, livestock farms are likely to be faced with transition issues given low incomes in 1994-95.

150,800 crop farms

Item	Dollars per farm
Gross farm income	\$230,237
Direct gov. payments	\$ 14,494
Net cash farm income	\$ 61,863
Net farm income	\$ 57,434

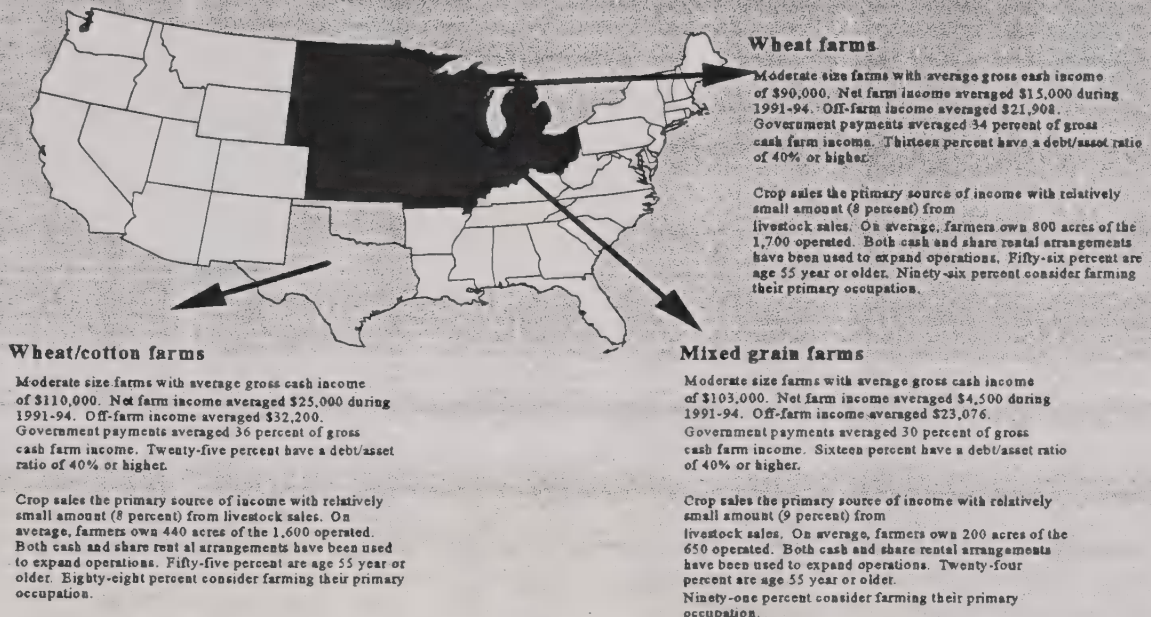
172,000 livestock farms

Item	Dollars per farm
Gross farm income	\$220,304
Direct gov. payments	\$ 8,360
Net cash farm income	\$ 37,659
Net farm income	\$ 24,375

- Over 60 percent of commercial farms are in a favorable financial position and many of those farms are not dependent on government payments (5 percent or less of gross farm income).
- Only 6 to 7 percent of commercial farms are classified in a vulnerable financial position--a debt-to-asset ratio of 40 percent or greater.
- Sector-wide, little added displacement is expected to result from FAIR, although livestock farms may be faced with greater transition issues given low incomes in 1994-95 and 1995-96.

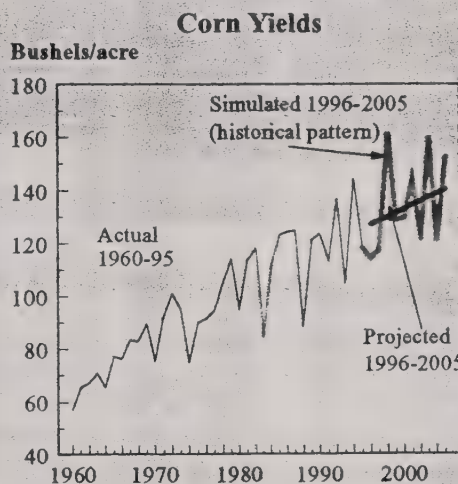
Farms Under Pressure

The financial transition will be greatest for 34,000 farms that are most dependent on government payments (20 percent or more of gross farm income).

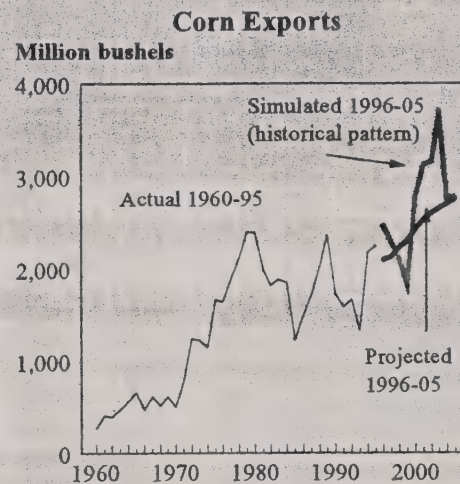


- Removing government influence on commodity production decisions means regions with natural comparative advantage--climate, soil productivity, alternative production possibilities, cost advantages, etc.--will be strengthened, but at the expense of "marginal" areas more dependent upon a "program advantage" than comparative advantage.
- Asset values, particularly land values, in marginal areas where values reflect existing commodity programs will drop. Areas with good productivity and cropping alternatives and less dependence on program returns could see asset values increase.
- Adjustment pressures will likely be greatest in the Northern Great Plains (wheat farms), the Western Corn Belt (mixed grain farms), and in the Southern Plains (wheat/cotton farms). Possible added stress in the Upper Midwest and the Northeast associated with reform in the dairy sector.
- The 34,000 farms identified as being most susceptible to financial restructuring have similar characteristics: moderate size farms with average gross cash incomes around \$100,000; government payments averaging over 30 percent of gross cash income; and a larger portion of farms in a vulnerable financial position (13 to 25 percent of the farms have a debt-to-asset ratio exceeding 40 percent).
- Vulnerable regions could see an acceleration of farm consolidations and further concentration of production in a small number of large farms.

Corn Yields and Export Variability



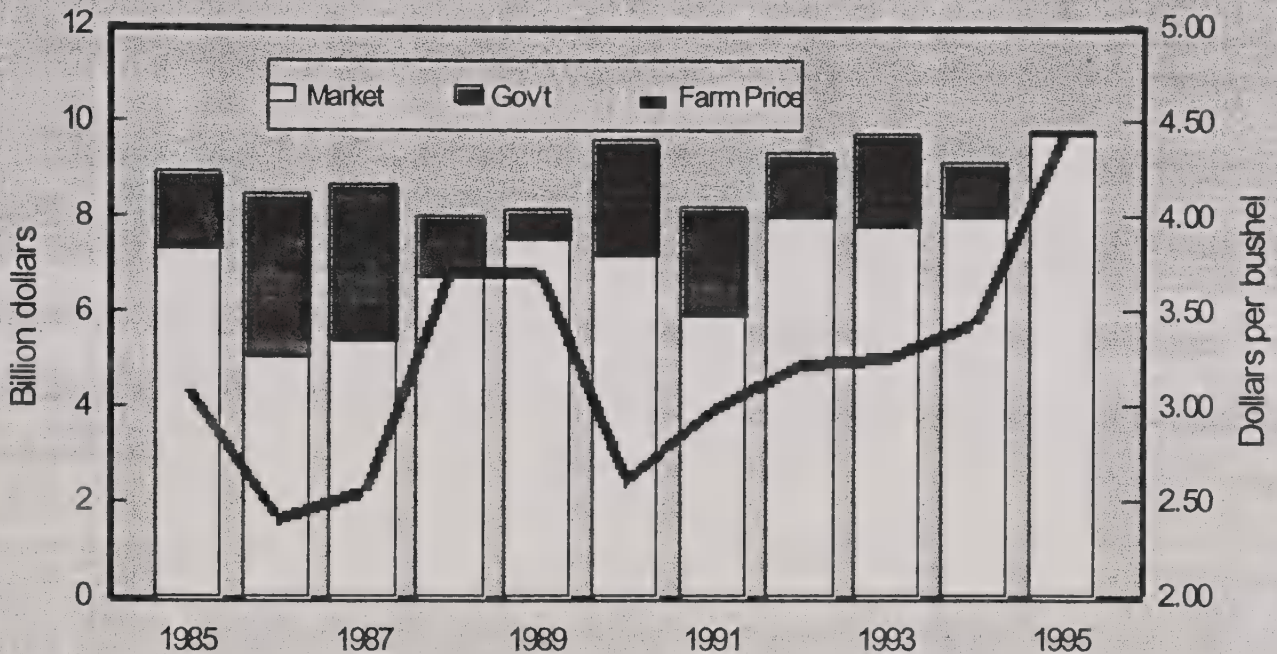
Baseline yield projections assume normal weather conditions throughout period.



Policy changes, political upheaval, or widespread crop failure could shift export demand in any given year.

- Projected supply and demand conditions are based on “normal weather” and trend yield growth. In reality, we can expect to see continued commodity market volatility on the basis of year-to-year swings in domestic yields and export demand.
- Market and price volatility has been a hallmark of the agricultural sector.
- Under previous programs, the government played a large role in attempting to manage market/price risk in periods of weak demand--through various supply control and stockholding programs.
- FAIR depends entirely on changes in market prices--not government programs-- to “equilibrate” supply and demand.
- Will commodity prices be more volatile under FAIR? Empirically, we don’t know. But, cash farm income could be more volatile.

Wheat Sector Revenue



- Under FAIR, any price volatility, and there has been quite a bit of year-to-year swing in prices in the last few years, will translate more directly to producer income volatility.
- Remember, under previous legislation government payments were linked countercyclically to market conditions, hence year-to-year swings in prices would be offset by changes in government payments.
- Wheat sector revenue (market revenue plus government payments), for example, has varied only between \$8.0 billion and \$10.0 billion over the past ten years, despite the much more volatile movement of wheat prices over the same period. Without government payments, income from the market only would have varied between \$5.0 billion and \$10.0 billion.
- Under FAIR, the government is removed from its role of bearing the market risk to producers in down markets. Farmers must bear more of the market price risk themselves.

Use of Risk Management Strategies, 1994

	All farms	Commercial farms		
		All commercial farms	\$100,000-\$999,999	\$50,000-\$99,999
Hedge or use futures markets	11	26	30	21
Contract crop/livestock sales	20	48	56	35
Spread sales over year	39	67	69	63
Forward price inputs	16	42	46	37
Keep unused borrowing capacity/Open credit line	35	66	69	61
Keep equity in cash & current assets	54	80	82	76
Produce stable or low-variability income commodities	28	50	52	48
Government program participation	42	71	96	96
Purchase crop or livestock insurance	40	71	46	46

Source: 1994 Farm Costs and Returns Survey

- Producers are already using many market risk management strategies. Producers are more often using strategies such as keeping equity in cash and current assets, buying crop insurance, and spreading sales over the year than they are hedging in futures markets.
- How do size and ability to manage risk interact? Smaller enterprises with a greater dependence on off-farm income in a stronger position to weather increased market volatility and income swings. Larger diversified operations in strong position to take advantage of production, marketing, and financial strategies to manage risk. Many of these larger farms, less dependent on government payments, are those already using a wide array of risk management strategies.
- The medium size farms (smaller commercial farms), appear to be the enterprises most in need of timely market information and a research and education program designed to identify alternative risk management strategies and to improve risk management skills.
- FAIR places a premium on management and the use of information to control costs and improve financial performance of farm operations

Risk Sharing Via Contracts Is Low, But Increasing For Field Crops

Output Under Production and Marketing Contracts

Commodity	1970	1994
Field Crops	2	8
Food grains	<1	13
Feed grains	11	20
Cotton		
Livestock	92	92
Broilers	60	65
Turkeys	95	95
Fluid grade milk	1	13
Hogs	18	11
Fed cattle		
Specialty Crops	85	88
Processed vgs.	21	25
Fresh vgs.	45	55
Potatoes	84	88
Citrus		

- The issue of price and income volatility and managing market risk goes beyond the farm gate to the food marketing system.
- Agribusiness has strong interest in dependable supplies, stable prices and constant margins rather than lower, but more volatile prices. Agribusiness is likely to join producers in search for risk management options.
- In food industries not covered by previous farm programs, such as livestock and horticultural products, risk sharing via production and marketing contracts has been a major risk management strategy.
- Output under production and marketing contracts for field crops is low, but increasing. FAIR could accelerate that trend in use of production and marketing contracts and other forms of "vertical coordination" for field crops.
- So, business strategies to reduce risk could have structural and vertical coordination implications.

FAIR ACCELERATES IMPACTS

- Economic efficiency gains in a more market-oriented sector
- Reduced role for government, particularly in stabilization of prices and incomes
- Increased income variability and increased responsibility for producers to manage market risk
- Business strategies to reduce risk could have structural and vertical coordination implications



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FAIR ACCELERATES IMPACTS

• Economic efficiency is a more

realistic goal for

• Reduced role for government and

stabilization of prices and incomes

• Increased income stability and increased

responsibility for producers to manage market

risk

• Business strategies to reduce risk could have

been developed earlier

... and the impact of the program would have been more significant